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State and Local Government

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STATE AND LOCAL GOVERNMENT

I. TAX INCREMENT FINANCING ACT IS CONSTITUTIONAL

Many states faced with urban blight have turned towards new forms of redevelopment financing in an effort to eliminate deterioration and to encourage private investment. South Carolina's new Tax Increment Financing Law[1] withstood a constitutional challenge in the recent decision of *Wolper v. City Council*.[2] The supreme court's opinion, written by Chief Justice Ness, illustrates the constitutional strength and unique character of this relatively new type of redevelopment financing.

The plaintiff, Jane Wolper, brought a declaratory judgment action against the City Council of Charleston to determine the city's right to issue tax increment revenue bonds. The issuance of the bonds had been proposed through a city ordinance enacted pursuant to the South Carolina Tax Increment Financing Act.[3] The Act authorizes municipalities to incur indebtedness for the redevelopment of areas suffering from urban blight. As the property in the redevelopment area increases in value, the debt is repaid through revenue gained from increased *ad valorem* property taxes. Before any redevelopment bonds are issued, the city must determine that the property values in the target area are either static or in decline.[4] The tax value of the property in the area is then frozen. Any tax revenue derived from an increase in property value above the "frozen base" is diverted to a special fund from which the redevelopment bonds are retired.[5] Revenue derived from the "frozen base" portion continues to be paid to the same funds as it did before the plan was initiated.[6]

After her complaint was dismissed by the trial court, the appellant raised four constitutional issues on appeal. Her first

1. S.C. CODE ANN. §§ 31-6-10 to -120 (Supp. 1985)(effective June 19, 1984).
2. 287 S.C. 209, 336 S.E.2d 871 (1985).
3. Brief of Appellant at 2.
4. 287 S.C. at 213, 336 S.E.2d at 874.
5. *Id.*
6. *Id.*

argument asserted that the diversion of *ad valorem* taxes to a special fund impaired the contractual rights of the city's general obligation bondholders to receive this revenue.[7] The supreme court reasoned, however, that the general obligation bondholders would receive the same amount of revenue from the "frozen base" as they would have if the plan had not been implemented.[8] The appellant next argued that the financing act created general obligation debt without regard to the constitutional ceiling on such debt.[9] In response, the court explained that tax increment bonds differ from general obligation debt because they are not secured by the full faith, credit, and taxing power of the municipality.[10] The bondholders may not look beyond the special fund and the project itself for security.[11] Tax increment bonds, therefore, are not as potentially burdensome on municipalities as general obligation debt and are not subject to the same debt limitation.

The appellant argued further that the Act violates article ten, section five of the South Carolina Constitution because it imposes a tax levy for an undeclared purpose.[12] The court, however, reasoned that since the Act simply diverts tax revenue, it imposes no new tax. Therefore, it is not a tax levy.[13] Finally, the appellant asserted that the Act was unconstitutional because it failed to serve a public purpose.[14] South Carolina is one of several states that has included a public purpose requirement for issuance of revenue bonds in its state constitution.[15] The state courts have been reluctant to define public purpose, however, viewing the concept as a fluid one that should be determined on

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7. *Id.* at 213-14, 336 S.E.2d at 873-74. S.C. CONST. art. I, § 4 prohibits the enactment of any law which impairs the obligation of contracts.

8. *Id.* at 213, 336 S.E.2d at 874.

9. *Id.* at 214, 336 S.E.2d at 874. The constitutional debt limitation is set forth in S.C. CONST. art. X, § 14(7).

10. *Id.*

11. *Id*; *see* Brief of Municipal Association of South Carolina as Amicus Curiae at A-7.

12. 287 S.C. at 214, 336 S.E.2d at 874.

13. *Id.*

14. *Id.* at 215, 336 S.E.2d at 875; *see* S.C. CONST. art. I, § 3. Although the pleading was improper, Chief Justice Ness recognized the importance of this issue and chose to address it.

15. S.C. CONST. art. I, § 3. Alaska, Wyoming, and Illinois also have public purpose requirements in their state constitutions. *See* Gillete, *Fiscal Federalism and the Use of Municipal Bond Proceeds*, 58 N.Y.U. L. REV. 1030, 1035 n.19 (1983).

a case-by-case basis.[16] Relevant factors have included the "promotion of public health, safety, morals, general welfare, security, prosperity, and contentment of all the inhabitants . . . ."[17] The supreme court in *Wolper* agreed with the trial court's determination that the target area in Charleston posed a threat to both health and safety and that the public would be the primary beneficiaries of any redevelopment.[18] The court noted that any benefit to private developers was incidental to the public purpose of renewal.[19]

The supreme court's treatment of public purpose is noteworthy when viewed with recent precedent. In an earlier case, *Byrd v. County of Florence*,[20] the court set out a four-part public purpose test that was used in the context of a general obligation bond issuance.[21] Justice Ness dissented, finding this test too stringent.[22] In *Wolper*, therefore, Chief Justice Ness veered away from this precedent. He gave the concept a broader reading by alluding to general notions of public health and welfare.[23] *Wolper* gives courts considerably more latitude when dealing with the public purpose issue. Moreover, the decision was made easier by the structure of the act. Section 31-6-30 requires five of fourteen conditions to be present before the target area is considered "blighted."[24] In addition, if the area is vacant, the act declares that economic growth is impaired if two of four conditions are met.[25] The Act, therefore, protects itself through these safeguards from a public purpose challenge.[26]

The supreme court's decision recognizes the need for urban redevelopment in some areas. Although the courts have discretion in imposing a public purpose requirement on a particular project, deference is given to the municipality provided that it

16. Byrd v. County of Florence, 281 S.C. 402, 404, 315 S.E.2d 804, 805 (1984).

17. *Id.*

18. 287 S.C. at 216, 336 S.E.2d at 875.

19. *Id. See generally* Davidson, *Tax Increment Financing as a Tool for Community Redevelopment*, 56 U. DET. J. URB. L. 405, 440-42 (1979).

20. 281 S.C. 402, 315 S.E.2d 804 (1984).

21. *Id.* at 407, 315 S.E.2d at 806.

22. *Id.* at 410, 315 S.E.2d at 808 (Ness, J., dissenting).

23. 287 S.C. at 216, 336 S.E.2d at 875.

24. S.C. CODE ANN. § 31-6-30(1) (Supp. 1985).

25. *Id.*

26. The Act declares its intent to serve a public purpose. S.C. CODE ANN. § 31-6-20(A)(4) (Supp. 1985).

works within the guidelines supplied by the act. Because this kind of redevelopment financing is essentially self-sustaining, the need for debt limitation is markedly less than it is for general obligation debt. Tax increment bonds are sui generis, and the court properly distinguished them from general obligation bonds. Tax increment financing has become a viable way for urban areas to raise money without the bureaucracy associated with federal assistance programs.[27] After *Wolper*, municipalities in South Carolina should make greater use of tax increment financing as a way to alleviate blight and to encourage private investment.

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II. BUSINESS LICENSE TAX ON REVENUES FROM INTRASTATE TOLL TELEPHONE CALLS IS UNCONSTITUTIONAL

In *Southern Bell Telephone and Telegraph Co. v. City of Spartanburg*[28] the South Carolina Supreme Court affirmed a circuit court order voiding the business license tax imposed on Southern Bell by the City of Spartanburg. The case arose when Spartanburg amended its business license ordinance in 1979 to tax telephone companies for local and intrastate business transacted in the city.[29] Under the amendment, Southern Bell, which for many years had been the largest *ad valorem* taxpayer in the city,[30] also became the largest license taxpayer in Spartanburg.

Southern Bell paid the taxes under protest and brought an action for refund, claiming the license tax violated its rights under the equal protection clauses of the South Carolina and United States Constitutions. The circuit court held that the tax denied equal protection of the laws because the city had no power to tax intrastate toll calls or revenues from services rendered to customers residing outside the city limits and that

27. Davidson, *supra* note 20, at 443.

28. 285 S.C. 495, 331 S.E.2d 333 (1985).

29. *Id.* at 496, 331 S.E.2d 334. The tax applied to Southern Bell's revenues from the entire Spartanburg exchange, although approximately 32,000 of the 47,000 customers in the exchange resided outside of the Spartanburg city limits. Record at 21.

30. *Id.* at 497 n.2, 331 S.E.2d at 334 n.2. Its license tax rate increased 900% to 1000%. A textile or manufacturing plant with the same revenue paid a maximum of $725. *Id.* at 497, 331 S.E.2d at 335.

there was no rational ground for the disparity of rates imposed on different businesses.[31] The supreme court affirmed.

The court agreed with the lower court's holding that the city had no power to tax intrastate toll (long-distance) calls made from or charged to a Spartanburg exchange number. Both courts relied on *Southern Bell Telephone and Telegraph Co. v. City of Aiken*,[32] in which the supreme court affirmed a circuit court holding that intrastate toll calls must be eliminated from Southern Bell's business license tax basis. The circuit court held that the inclusion of intrastate toll calls would allow Aiken to tax outside of its territorial jurisdiction, that there was no rational manner in which such calls could be apportioned among various taxing jurisdictions, and that *Triplett v. City of Chester*[33] was inapplicable to the situation.

It is clear after *Aiken* and *Spartanburg* that municipalities cannot include in the revenues of telephone companies those revenues derived from intrastate toll calls. This is a sound decision since a number of jurisdictions may be involved in the relaying of a long-distance call.[34] The connection between a municipality and a telephone company involved in the mere relay of a toll call is too tenuous to characterize the activity as doing business within that city.

Although the supreme court affirmed the lower court's decision that the city lacked power to tax services rendered to customers outside the city limits, the proposition does not apply in

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31. Record at 25.

32. 279 S.C. 269, 306 S.E.2d 220 (1983). In *Aiken* Southern Bell had appealed from a judgment enforcing Aiken's license tax ordinance. In its cross-appeal, the city urged that the trial court erred in holding that Aiken had no power to include intrastate toll calls in the revenues of Southern Bell for business license tax purposes.

33. 209 S.C. 455, 40 S.E.2d 684 (1946). In *Triplett* the taxpayer challenged the applicability of Chester's license tax to him when all the paving work he did was performed outside the city limits. The court found for Chester, holding that "[t]he right of a municipal corporation to impose a tax of this kind upon a corporation or business conducted within the city limits, although a portion of the business is carried on or the transaction is factually completed outside such municipality, is generally recognized." *Id.* at 461-62, 40 S.E.2d at 686.

34. Although distinguishable, this issue is analogous to the issue of taxation of services rendered to customers residing outside city limits. *Spartanburg* and *Aiken* held that intrastate toll calls cannot be included in taxable revenues whether the customer resides in the city or not. *See* 285 S.C. at 495, 331 S.E.2d at 333; *Aiken*, 279 S.C. at 269, 336 S.E.2d at 220.

all circumstances. The court did not mention *Triplett*,[35] which presumably remains valid. As noted in *Triplett*, "[i]t frequently happens that there is a business located within a municipality that does not do *all* of its business within the corporate limits of such town or city."[36] The degree of connection between the extraterritorial activities of a business and the city seems to be the proper way to determine the propriety of including revenues from such activities in the tax basis of a business license taxpayer.[37] The absence of a formula by which to apportion shares of intrastate calls, rather than the extraterritorial nature of such calls, was the foundation for Circuit Judge Peeples' decision in *Aiken*. The court concluded that Aiken could not tax the calls.[38] The technological complexities of the telephone industry underlie the holdings in *Spartanburg* and *Aiken* that services to customers outside city limits cannot be taxed by cities. In a different situation, such as that in *Triplett*, a city may have the power to tax the revenues of a concern even though some of the revenues are derived from services rendered to customers outside the city limits.[39]

In ruling that the tax violated Southern Bell's rights of equal protection, the court relied on two cases in which insurance companies challenged municipal license taxes. The court referred to *United States Fidelity and Guaranty Co. v. City of Newberry*,[40] which involved a challenge by an insurer to a business license tax rate which was seven times higher than the next

35. 209 S.C. 455, 40 S.E.2d 684 (1946).

36. *Id.* at 459, 49 S.E.2d at 685 (emphasis in original).

37. In *Triplett* the court found that although a taxpayer's paving work was done outside of the city, his equipment was stored in town, and the managerial and executive aspects of the business were carried on in the city of Chester. On these facts the court found the business license tax properly applicable to the taxpayer. *Id.* In *Spartanburg* the particular nature of the telephone services rendered outside the city limits made the connection much less strong. Nonresident Spartanburg exchange customers may activate equipment in Spartanburg when making calls, but the billing and other managerial duties of Southern Bell relevant to those customers are chiefly performed elsewhere. Record at 166.

38. The trial judge implicitly recognized that cities might properly tax revenues derived from services outside the city depending upon the particular circumstances when he deemed *Triplett* inapplicable to the facts of *Aiken*. He noted that the court in *Triplett* did not seem to consider the extent to which a city may lawfully tax the extraterritorial revenues of a business. Brief of Respondent at 40.

39. *See Triplett*, 209 S.C. at 461-62, 40 S.E.2d at 686.

40. 257 S.C. 433, 186 S.E.2d 239 (1972).

two categories of businesses and twenty times higher than all other categories.[41] The *Newberry* court affirmed the basic proposition that a city may tax different business classes at different rates. In addition, *Newberry* held that a presumption of validity attaches to license taxes, and courts should not interfere with such taxes unless they are clearly unreasonable and oppressive. A plaintiff who challenges license taxes has the burden of proving invalidity.[42]

Thus, one attacking a license tax must show some disparity between rates of different classes. If sufficient disparity is shown, the burden shifts to the city to justify it.[43] The court in *Spartanburg* found that Southern Bell met its burden. It deemed the disparity in tax rates "gross" and held that Spartanburg did not meet its burden because it failed to advance a reasonable basis for the differential treatment.[44] The court implied that the tax could have been justified if the increase had been part of an overhaul of the entire ordinance and if the city had shown that Southern Bell benefited from city services more than other businesses. This latter consideration was recognized as a justification for disparate tax rates in *United States Fidelity and Guaranty Co. v. City of Spartanburg*,[45] upon which the court relied.

A business license tax, therefore, is presumed valid, and a taxpayer must show a disparity before the courts will interfere. If a disparity is shown, the burden shifts to the city to justify the tax rate. It is unclear exactly how disparate the tax rates

41. *Id.* at 437, 186 S.E.2d at 240.

42. *Id.* at 438, 186 S.E.2d at 241.

43. In *Newberry* the court found a "gross" disparity and remanded the case "to give the city of Newberry an opportunity upon trial to justify, if it can, the classification and rate of tax as being constitutionally permissible." *Id.* at 443, 186 S.E.2d at 243.

44. 285 S.C. at 497, 331 S.E.2d at 335.

45. 263 S.C. 167, 209 S.E.2d 36 (1974), *aff'd*, 420 U.S. 968 (1975). In this case, the disparity of rates was substantial enough to incite inquiry, but the tax was found to be justifiable for two reasons. First, insurance companies benefit from city services such as fire and police protection more than other business. Second, the insured pays little *ad valorem* tax. The court in *Spartanburg* also noted that Southern Bell was the largest *ad valorem* taxpayer in the city. 285 S.C. at 497 n.2, 331 S.E.2d at 334 n.2. Interestingly, the supreme court in North Charleston Land Corp. v. City of N. Charleston, 281 S.C. 470, 316 S.E.2d 137 (1984), held that the fact that certain businesses paid high *ad valorem* taxes and required little in the way of city services was a rational basis for exempting the businesses for license taxation. The supreme court recently reaffirmed the basic validity of disparate tax rates for different classes of businesses in Thompson Newspapers, Inc. v. City of Florence, 287 S.C. 305, 338 S.E.2d 324 (1985).

must be before inciting inquiry. In *Spartanburg* the central reason for the court's finding may have been the city's motive to drastically increase the tax on Southern Bell, since Duke Power had agreed to pay the city three percent of its gross revenues.[46]

Spartanburg makes clear that cities may not tax revenues derived by telephone companies from long-distance intrastate calls and service to customers outside city limits. The decision regarding nonresident customers is narrow and should not be interpreted to mean that cities may not under any circumstances tax revenues derived from services to customers outside city limits. The particular nature of the telephone service business accounts for the cited holdings regarding intrastate toll calls and nonresident customers. The reasoning behind these decisions may be of limited use in other situations involving city license taxes. The equal protection analysis in *Spartanburg*, however, is more broad and has wider application to license taxation in general. *Spartanburg* is useful to those attacking or defending a license ordinance. The supreme court gives cities notice that although their power to tax businesses is largely discretionary, this power is not unfettered. Cities must be prepared to defend a tax rate which places a substantially higher burden on one particular class of business.

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46. 285 S.C. at 498, 331 S.E.2d at 335.